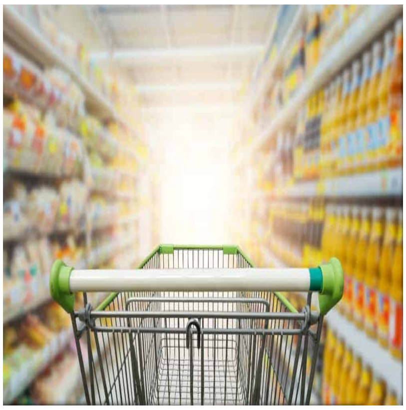

Why Loblaw’s (TSX:L) Stock Price Fell 3.8% Yesterday

Description

Loblaw’s (TSX:L) stock price has been having a pretty good 2020 so far. It is up 5.7% year to date and up 18.6% from March lows. Clearly, Loblaw stock has been a solid defensive holding through this rough period.

Yesterday, Loblaw reported first-quarter earnings that were boosted by a March demand surge. Revenue increased 10.8% and earnings surged 30%. So, why was Loblaw’s stock price down yesterday off these results?

Loblaw’s stock price falls on revenue mix changes

Breaking down Loblaw’s results, we can see some trends emerge. Firstly, much of the extraordinary revenue growth occurred in the last two weeks of March. There has been sustained increased buying since then, with less attention to price. This can be expected to continue in the short term. The longer the crisis goes on, however, the more likely we will start seeing greater economic hardship and pricing sensitivity.

Secondly, e-commerce volume increased threefold due to the pandemic. This makes total sense. Given the circumstances, Loblaw has eliminated pick-up fees and lowered delivery fees. Management is unsure how long this will last, but this is a pressure point on margins.

And thirdly, higher-margin product revenue declined significantly as part of customers’ pandemic response. Lower sales of higher-margin categories like general merchandise, apparel, and beauty products will negatively impact margins going forward.

Expect second-quarter, COVID-related costs to hit Loblaw’s stock price

Increased costs related to keeping employees and customers safe will pressure results. Increasing wages and cleaning practices, and the installation of plastic barriers and other safeguards are big investments. According to management, this increased cost structure will persist for at least the next quarter. While visibility is low, we can safely assume that this pressure may remain for the full year. The estimated incremental cost due to the pandemic will be $90 million per month.

This will have a significant negative impact on Loblaw's earnings.

Loblaw stock is attractive due to its defensiveness

Even with these hits to Loblaw's financials, Loblaw stock is still attractive. This is due to its involvement in the consumer staples and pharmacy businesses, which will withstand this crisis. This is also due to the fact that Loblaw is in good financial shape. In the first quarter, the company generated $1.1 billion in free cash flow. Lastly, this is due to the fact that Loblaw is Canada's largest food retailer and leading pharmacy outlet.

Even in this more difficult environment, Loblaw can be expected to maintain its leadership positions. The company has strong private label brands and leading market share in prescriptions and front store sales at Shoppers Drug Mart. This will all continue to work to solidify the company's value proposition and its free cash flow generation.

Foolish bottom line

Loblaw's stock price reacted negatively to first-quarter results yesterday. The stock got hit, even though the company is seeing unprecedented, booming demand. If we lift the curtain, we see a lot of pressure on costs and margins. This has left investors with a negative reaction. Now, we have to weigh this margin pressure with other factors. At least Loblaw is open for business, and that is a comparatively good spot in today's environment.

CATEGORY

1. Coronavirus
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